

TEACHERS' RETIREMENT BOARD

INVESTMENT COMMITTEE

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SUBJECT: Alternative Investment  
Tiered Rating System

ITEM NUMBER: 7

ATTACHMENT(S): 1

ACTION: \_\_\_\_\_

DATE OF MEETING: August 5, 1998

INFORMATION: X

PRESENTER(S): Mr. Desrochers

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**EXECUTIVE SUMMARY**

In accordance with the Alternative Investment Policies, the primary objective for the alternative investment portfolio is to provide enhanced investment returns over those available in the public market. The Alternative Investment staff will achieve this objective by investing in partnerships with higher expected returns, purchasing secondary interests in limited partnerships, and developing and implementing a successful co-investment program.

Staff has developed a tiering model to assist in the on-going monitoring and due diligence process of the alternative investment portfolio. The model is designed to assist staff in identifying partnerships with higher expected returns. The tiering model will not replace the existing criteria that STRS utilizes when conducting due diligence on a new partnership. Instead, it will enhance the process by adding additional resources to the decision making process.

A description of the tiering model and a discussion of the evaluation process is contained in Attachment 1.

## PURPOSE

The purpose of the tiering model is to create a tool that will assist Staff in the on-going monitoring and due diligence process of the alternative investment portfolio. Specifically, the tiering model will encourage Staff to guide the alternative investment portfolio towards future investments in its best performing partnerships, and will direct the selection of new partnerships with specific quantitative and qualitative objectives. This is accomplished through an on-going monitoring and due diligence process that categorizes STRS' partnerships by tiers.

The tiering model is designed to be utilized in the implementation of the alternative investment policies. That is, its purpose is to assist Staff in identifying partnerships with higher expected returns. An ancillary benefit of the tiering model is that it will also assist Staff in identifying the problematic partnerships. The categorization of Tier 3 partnerships will provide Staff with a "watch-list" of problem partnerships. "Next-step" monitoring tasks will be assigned to each of these funds.

The tiering model will not replace the existing criteria that STRS utilizes when conducting due diligence on a new partnership. Instead, it will enhance the process by adding additional resources to the decision making process.

## DESCRIPTION

Staff will assign a Tier 1, Tier 2, or Tier 3 rating to each of STRS' partnerships relative to how their performance and other criteria (described below) measure against their peers. Tier 1 partnerships are STRS' best performing partnerships. Ideally, Staff would like to maximize the amount of capital committed to invest with these partnerships going forward. Tier 3 partnerships are STRS' worst performing partnerships. It is extremely unlikely that these partnerships would receive investment capital from STRS going forward. Tier 2 partnerships that are raising additional capital will likely require the most work from Staff. Careful consideration must be given to these partnerships in order to determine STRS' investment interest going forward. In certain circumstances it is likely that Staff may determine that the potential rewards of investing in Tier 2 partnerships may outweigh the associated risks. Nevertheless, it must be emphasized that it is Staff's intention to focus future efforts on the Tier 1 partnerships.

## FREQUENCY OF EVALUATION

The tiering model must be an ongoing process. On-going due diligence and monitoring of each of STRS' partnerships will provide Staff with the ability to continually tier each of STRS' partnerships. This is important because the data used to tier each of the partnerships may change frequently. As personnel changes, portfolio companies improve or suffer, or a STRS' relationship changes, adjustments to the tiering model should be made immediately. Therefore, at a minimum, tiering updates should occur on a quarterly basis. Re-evaluation may be necessary when any of the following significant events occur:

1. Staff meets or speaks with the management team regarding significant issues.
2. Updated performance is calculated.
3. The loss of a key partner occurs.
4. Deficiencies in STRS' relationship with a general partner appear.
5. Quarterly and/or annual portfolio reviews are conducted
6. A new fund is being raised by the partnership.

### EVALUATION PROCESS

Tiering will be measured under five main categories:

- Performance history of the partnership
- Investment strategy adherence and investment pace
- Continuity and history of the management team
- Partnership relationship with STRS
- Co-investment ability and corresponding terms

As the tiering model continues to develop, Staff believes other categories might be revised or added to the model. Further, it may eventually be determined that existing categories should not be included. Lastly, Staff expects that the weightings assigned to each of these categories will change as Staff continues to improve the tiering model. Currently, the following weightings have been assigned to each of the five major tiering categories.

<u>Performance</u>	<u>Investment Strategy</u>	<u>Mgmt. Continuity</u>	<u>Relationship</u>	<u>Co-investment</u>
40%	20%	20%	10%	10%

### Performance History of the Partnership

As illustrated above, the most heavily weighted tiering category is the performance history of the partnerships. The performance history of each of the STRS' general partners' prior funds are compared against the Venture Economics industry benchmark and assigned a ranking between 1 and 10, 10 being the highest. Partnership returns that report figures above the benchmark's upper quartile will receive the highest ranking, while partnerships with returns below the median will receive the lowest ranking.

It is extremely important to note that much of this data is only verifiable at specific points in time, i.e., quarterly and annual financial review, when the general partners are raising a new fund, or when it is specifically requested by Staff. While Staff can easily track the performance of its existing partnerships, it is more difficult to obtain the performance of partnerships in which STRS is not an investor. For example, in some circumstances, performance rankings have been assigned based on data that is already several years old. As Staff continues to update the partnership's performance rankings during the on-going tiering process, it is likely that some partnerships may move away from their existing tiering category.

### Investment Strategy Adherence and Investment Pace

Staff will weight the partnerships' adherence to their originally stated investment strategy. An investment strategy that suddenly shifts or continues to change over time likely indicates a general weakness in the original strategy. Therefore, the investment strategy utilized by the partnership will be reviewed for each of its prior funds as well as the current fund and proposed fund. Further, partnerships with a proven, successful, and proprietary processes will be awarded higher points.

Additionally, points will be awarded, or deducted, after consideration is given to the partnership's investment pace. A slow investment pace may be an indication of poor deal flow or a demanding time schedule that permits little time for new investments. However, careful consideration must be given to the partnership's investment pace as it is also possible that general partners may intentionally be slowing their pace as pricing moves to lofty levels.

The weighting scale for this category will be from 1 to 10, 10 being the highest.

### Continuity and History of the Management Team

Consideration will be given to the length of time that the individuals comprising the general partner have been working together. Clearly, a team of individuals that have been working together for a long period of time with little or no senior turnover pose less risk than a firm that has been together for only a brief period of time or that has experienced significant turnover.

Consideration will be given to the age of the general partners, prior experience, and composition of the management team. A management team that has a depth of experienced investment professionals, supported by a fair mix of junior partners and analysts, and complemented by a solid support staff, will be awarded higher points. Additional points will be assigned to general partners who have significant investment experience and an equitable sharing of economics between the principals of the partnership.

The continuity of the management team will be determined and assigned a ranking. Initially, it will be assumed that the general partner team is working well together. Points will be deducted from the partnership if negative feelings are uncovered in the due diligence process, or if Staff feels that the sharing and vesting of the carried interest amongst the principals is not lending itself to maintaining a strong and cohesive management team.

The weighting scale for this category will be from 1 to 10, 10 being the highest.

### Relationship with STRS

Staff believes it is extremely important to continue to nurture and improve its relationships with the general partners of STRS' alternative investment partnerships. General partners that have the best relationships with STRS are likely to provide STRS with the ability to invest larger amounts

of capital, remain receptive to suggestions made by STRS as an advisory board member or limited partner, and/or offer co-investment opportunities to STRS whenever possible.

Relationships will be measured by considering the level of communication the partnership provides to Staff, whether or not STRS has been offered a board seat on its partnership investments, and the quality and timeliness of the partnership's reporting process.

Further, Staff also believes that the alignment of interests between the general partner and limited partners should be considered in the analysis of the relationship. Therefore, the specific legal and economic terms of each limited partnership agreement, and the amount of capital the general partner has committed to the partnership, will be included in the ranking.

The weighting scale for this category will be from 1 to 10, 10 being the highest.

#### Co-investment Ability and Corresponding Terms

Special equity partnerships that provide STRS with an ability to co-invest in their deals will be awarded points. Further, those partnerships that provide favorable co-investment terms to their co-investors will be awarded additional points. No points will be awarded to those partnerships that do not provide STRS with the ability to co-invest.

Staff will also consider the willingness of the general partner to provide STRS (or the existing limited partner base) priority in a secondary interest offering. Additional points will be awarded to those partnerships that provide a secondary priority to STRS.

The weighting scale for this category will be from 1 to 10, 10 being the highest.

#### Evaluation of New Partnerships

Potential investment opportunities with a partnership that is new to the STRS portfolio will be evaluated with the same due diligence process that both Staff and consultant currently have in place. Therefore, the tiering process is intended as an additional tool to the due diligence process to evaluate new partnerships.

Initially, all new partnerships will be ranked in the STRS' portfolio as Tier 2 partnerships. It is expected that new partnerships will ultimately move to the Tier 1 ranking after a sufficient amount of time has passed to accurately rank the partnership performance.